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AUTHOR(S):

Asutay, Mehmet

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Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy *vs* the Realities of Islamic Finance

Mehmet ASUTAY *

Abstract

Islamic moral economy emerged in the modern sense in the late 1960s and early 1970s as an attempt to develop an authentic understanding of the Islamic system of economics and develop policies accordingly. As part of this concept, Islamic banks and financial institutions are considered as the institutional aspects of this moral economy, which can pool their resources together to finance real economy activity. However, the transformation of Islamic banking into a commercial banking form since mid-1975 has resulted in unprecedentedly successful financial performance, which, however, has been at the expense of the 'social and economic developmentalist' aspirations of Islamic moral economy. Therefore Islamic banks and financial institutions are criticised for their social failure. This paper, therefore, aims to explore the social failure of Islamic banks and financial institutions and locate the sources of this failure. In moderating the social failure of Islamic banks and financial institutions, this paper suggests that a third institutional development in the form of non-banking financial institutions, such as Islamic social banking, Islamic microfinance, an *awqaf* system, *ar-rahn* or Islamic pawnbroking, and *zakah* funds should be created with the objective of serving the social and developmental needs of Muslim societies.

Introduction

The search for authentic Islamic institutions set the objective of the Muslim societies in the 20th century, which took shape in the case of financial institutions in the last quarter of the century in the form of Islamic banks and financial institutions (IBFIs). With the establishment of first Islamic bank (IB) in 1975 in the Gulf, institutional development took the 'commercial form' as opposed to the short-lived experience of Islamic social banking as experienced in the case of Mith Ghamr in Egypt in the 1960s.

Since the first IB in 1975, IBFIs has successfully expanded in their asset bases but also in terms of the number of such institutions. An important success of IBFIs is the institutional

* Reader in Middle Eastern and Islamic Political Economy & Finance, Durham Centre for Islamic Economics and Finance, School of Government and International Affairs, Durham University
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developments that have taken place in West as well, such as in London, Paris, Rome, and Luxembourg among other countries that have attracted IBFIs.

Against the backdrop of the global financial crisis, IBFIs have managed to achieve modest growth in their asset bases and also in other institutional and financial variables. Therefore, the 'resilience of IBFIs' has become a popular topic in conferences and writing, and in such articulations this 'resilience' is attributed to the religio-ethical foundations of Islamic banking and finance (IBF). However, defaults in IBFIs have happened as well, in particular in Dubai, which has brought the whole idea of resilience into 'question.'

A critical analysis of the progress, expansion and performance of IBFIs indicates that the values and norms of IBF are compromised for 'financialisation' through financial engineering, which helped to endogenise the problems of the 'current financial system' into the IBFI realm. It is therefore important to make reference to the norms and values of IBFIs as formulated by the Islamic moral economy (IME), which give meaning to the 'Islamicness of IBF.' For this, the framework of IME should be articulated and IBF should be located within this framework in order to express the distinguishing nature of IBF as a valued proposition.

This paper, therefore, aims to present the moral economy basis of IBF and compare its performance against the value proposition articulated by IME whereby the 'social failure' of IBF is identified.

1. Islamic Moral Economy as the Foundation of Islamic Finance

Islamic economics or as argued by this paper Islamic moral economy (IME) emerged mainly in the post 1960 period as a result of a search for reform in the Muslim world since the beginning of the 20th century. In the post 1960s period, the failure of economic development in the Muslim world and the rise in the Islamic political identity motivated certain academics, activists and financiers/bankers to discuss the initial foundational issues of what was later to become Islamic economics or IME. Thus, IME is a response to the failure of economic development in the Muslim world, whether capitalist, socialist or nationalist, with an authentic meaning derived from the ontology of Islam, namely the *Qur'an* and the *Sunnah* or the traditions of the Prophet of Islam [Asutay 2007a, 2007b]. It is in a way a reaction and problem solving attempt to develop an 'Islamic system' of economics and economy in producing a theoretical policy base to counter the underdevelopment of Muslim societies through the norms, values, and principles of Islamic ontology with the objective of creating a human centred development process.

A number of academics, such as M. Umer Chapra [1992, 2000], M. Nejatullah Siddiqi

[1981], Khurshid Ahmad [1979, 1994, 2003], S. H. Naqvi [1981, 1994, 2003] in 1970s, as the founding fathers of Islamic moral economy in modern sense, attempted to articulate the initial theoretical building blocks of IME and therefore IBF. As a modernist movement, IME in the process has been socially constructed within the ‘socially’ understood meaning of Islamic ontology. In this reading, and therefore, formulation, emphasis was placed on the consequentialist nature of economic development and the substance of the process, which, as a result, produced a ‘social-welfare’ or ‘social good’ oriented developmentalist paradigm. The concepts of ‘*adalah*’ or ‘justice’ and ‘*haqq*’ or ‘right’ are the core objectives and operational functions for understanding this alternative system.

The initial attempt to formulate the ‘Islamic system’ of economics aimed at laying the axiomatic foundation of IME, with direct consequences and implications for the social aspects and developmentalist orientation of IME, as presented below [Asutay 2007a, 2007b; Naqvi 1981, 1994; Ahmad, K. 1979, 1994]:

- (i) The vertical ethicality of the equality of individuals in their relations to the Creator, God, and having equal opportunity to enjoy the bounties on Earth created by God; namely *tawhid*;
- (ii) Social justice and beneficence (*adalah* and *ihsan*), which constitutes the horizontal equality between individuals within the *tawhidi* framework;
- (iii) As a direct result of the vertical and horizontal ethical axioms, IME assumes growth in individual, social, economic and biological environments to take place in harmony with the stakeholders within the spiritual framework of *tazkiyah*;
- (iv) IME, as a consequence of the above axioms, assumes in a functional sense an enabled individual, society and natural environment so that each of these can reach its perfection within the *tawhidi* framework, as God has chosen perfection as a path by definition for everyone and everything. This refers to *rububiyah* as the functional axiom;
- (v) In fulfilling *rububiyah* in all aspects of individuals, society, economy and environment the *tazkiyah* process aims to overcome the conflict between individuals and society. Therefore, IME assumes that in order to overcome the perceived conflict between the individual and society, voluntary action is not perceived to be enough; and therefore certain socially oriented financial and economic obligations are made mandatory, or *fard*, so that moral economy objectives can be achieved;
- (vi) In operationalizing such expectations as expressed within the axioms of IME, as part

of the *tawhidi* framework, individuals are perceived to be the vicegerent of God on the Earth, namely *khalifah*, and expected to fulfill their duties within the social, economic, financial and other realms and to make their decisions through a moral filter. In other words, since individuals are considered to be the representative of God on Earth, they are expected to fulfill such roles and responsibilities.

All these axioms, as the foundational framework of IME, are the articulation and operationalisational aspect of *maqasid al-Shari'ah* or the 'objectives of Shari'ah' process, which is defined as realizing 'human well-being.' In other words, the entire objective of IME and also its operational aspect of *Shari'ah* is to serve 'human well-being' which is the main and essential aim of all efforts within the *tawhidi* framework.

It should be noted that IME assumes a morally oriented individual at its methodological base, which can be considered as '*homoIslamicus*' [Asutay 2007a, 2007b]. Such an imagined individual is expected to aim at achieving '*ihsan*' or 'beneficence/excellence' in whatever he/she does through the '*falah*' or 'salvation' process in this world and the Hereafter [Zaman and Asutay 2009]. Thus, endogenising 'Hereafter' as an essential part of perpetual life spiritual accountability is introduced to the individual objective function, as one might aim at maximizing the benefits in this world but has also to be concerned with the consequences of such actions in the Next, as one has to aim to maximize the *falah* for the Hereafter as well. Thus, two-dimensional utility maximization is a process considered and theoreticised by IME.

In terms of the consequentialist approach, as implications, the foundational axioms demonstrate, as a system, that IME refers to economic and sustainable development, social justice and social investing oriented principles. They assume a human centred development strategy with individuals aiming to reach *ihsan* or beneficence or excellence due to aiming for *falah* or salavation in this world and in Hereafter as the aim of this life. Within such a framework, IME assumes to develop functioning individuals in terms of 'doings' and 'beings' through creating the right and just environment and opportunity spaces for such development to take place [Zaman and Asutay 2009].

IME is thus based on system understanding by directly defining foundational axioms, values and norms, a particular methodology, operational principles and functional institutions. As examined by Asutay [2007a], IME fulfils all these conditions to be considered as a system. It is only within the system of IME that IBFIs are considered as functional institutions in terms of raising and pooling the necessary funds and financing for economic activity, progress and

development. Thus, IME is a moral system of economy and society providing a systemic approach to the economic sphere through a multi-dimensional and multi-disciplinary approach. IBFIs therefore, should be located within this framework and systemic understanding in order to serve the aims and objectives of IME and therefore contribute to the *falah* process for individuals by expanding the *ihsani* social capital in the society. Therefore the following section, aims to locate the ethical foundation of IBFIs.

2. Islamic Banking and Finance as a Value Oriented Proposition

As discussed in the previous section, IME assumes and offers a moral based value solution for the economic and financial problems faced by the humanity. When the current global financial crisis hit the world, people from different circles criticised capitalism for its ‘moral deficiency’ and attributed the financial failure not only to ‘reckless financing’ instruments but also to the ‘greed’ of the financiers and bankers. Therefore, the financial crisis brought the importance of ‘morals’ into the agenda with the objective of ‘moderating’ the consequences of the ‘capitalist financial system.’

The origin of Islamic banking and finance (IBF) can be traced to the initial years of the Islamic civilisation, as Islam through its teaching under the supervision of the Prophet of Islam aimed at regulating and shaping economic and financial activity according to the moral norms and values of Islam. While in one way or another such a tradition continued to exist at the periphery of the Muslim world, its re-mergence with systemic understanding has only been possible in post the Second World War period when some of the newly independent Muslim states searched for an authentic meaning for economic and financial activity through Islamic values. Therefore the rise of IME is a result of this authentication process with the objective of creating an economic system with understanding of Islam.

IME, however, refers to a ‘system,’ which in essence is possible only through a political process [Asutay 2007a]. Since changing the political process to bring a new system is not possible, IBF was considered by the founding father as the plausible institutional dynamics of IME, and therefore the modern versions of banks in the form of IBFIs have operated commercially since mid-1975. However, these commercial IBFIs should be considered as the second stage, as initially in 1963, Mith Ghamr Bank was established in Egypt based on the moral economy understanding of Islam beyond commercial IBF, as Mith Ghamr Bank aimed for capacity development, and economic and individual development [Mayer 1985]. This social bank, which constitutes the initial institutional nature of IBF, aimed at providing credit

to small entrepreneurs and artisans with the objective of empowering individuals against the overwhelming power of the state. However, the operation of this bank could not be sustained, as the consequences of its operation disturbed the political power base in the country, and therefore later it was closed by the regime towards the end of the 1960s. Thus, the moral consequences of a 'true' Islamic bank (IB) were rather evident in the operation of Mith Ghamr which remains as an aspirational 'role model' today.

Over the years, since the establishment of the first commercial IBF in Dubai (Dubai Islamic Bank) in 1975, IBF has become a reality beyond the Gulf region. The performance of IBFIs in the last thirty-five years indicates that this banking and finance proposition has been unprecedently successful despite an entirely adverse attitude from the Muslim authorities in Muslim countries and beyond [Iqbal and Molyneux 2005]. The recent reports demonstrate that the assets of IBFIs have reached about USD 1,2 trillion, which of course still constitutes a small portion of the global financial system [*The Banker* 2010]. However, this performance should be considered against the background of simply starting from zero level in 1975. As to the performance of IBFIs, until the recent financial crisis, these institutions grew by 15-20% per annum. However, since 2008, their growth has been more modest, less than 10% per annum, which is still higher and better than the performance of the conventional banks and financial institutions.

The success of IBFIs can be seen in its geographical diffusion to many countries in the world, about 55 countries, financing everyday goods and services consumed all over the world. By the end of 2010, it is reported that there were about 650 IBFIs in these 55 countries [*The Banker* 2010].

This unprecedented success has attracted the attention of non-Muslim countries too, resulting in a number of Western nations adopting new strategies to facilitate and accommodate IBFIs in their own countries, which include Great Britain, France, Switzerland, and Luxembourg among others [Wilson 2007].

Despite the observed 'financial' success, it is important to critically evaluate the performance of IBFIs against their foundational base, namely IME, as IME imposed generating the necessary funding and financing for economic development within the norms of the social and moral economy of Islam by conceptualising it as a 'financing' proposition as opposed to 'financialisation' of the economy; the latter is considered as one of the main sources of the collapse of the financial systems in the West. As the IME framework suggests, ethicality in this value proposition in the original sense is not only the prohibition of *riba* (interest) but relates to larger social and

economic development issues as discussed above [Asutay 2007b, 2010b]. In other words, IME conceptualises IBF as a financing proposition shaped not only by the rules (*fiqh*) but also by the moral values of Islam constituting the ‘substance’ [Asutay 2008].

IME’s moral framework, thus, aimed at shaping the nature and operation of IBF beyond the prohibition of *riba* or interest. In this moral based financing proposition, a holistic approach to financing a society is assumed by IME. This Islamic value and norms based nature of IBF can be described as follows [Asutay 2007b, 2010b; Iqbal and Molyneux 2005; Ayub 2007]:

- (i) IBF is a tenant based financing proposition, as fundamental tenants are derived from the ontological sources of Islam, which is articulated in the ‘absence of interest-based transactions,’ ‘avoidance of economic activity involving speculation,’ and the ‘prohibition on production of goods and services which contradict the values of Islam.’
- (ii) IBF is principles based, as the concept is grounded in ethics, values and norms derived from the Islamic ontology. Therefore, the principles of IBF are akin to ethical investing, and therefore, ethicality in funding and investing beyond the prohibition of *riba* is essential. In addition, importantly, IBF puts special emphasis on risk-sharing and partnership or profit-and-loss sharing contracts. In this financing proposition ‘credit and debt products are not encouraged’ and were even eagerly discouraged so that real economy embedded financing as assumed by IME could be developed.
- (iii) IBF, as part of IME, proposes embedded financing—embedded in real economy, and therefore it offers an alternative financing paradigm. This is articulated in the principle of asset-backed transactions with investments in real, durable assets to contribute to the development of value added oriented real economy based financing of economic activity. As a consequence, IBF aims to bring about stability by linking financial services to the productive, real economy. On the demand side, IBF, as part of *homoIslamicus*, aims to restrain consumer indebtedness as credit is linked to real assets.
- (iv) IBF is a society oriented financing proposition, as it aims to serve the community and not the markets. Since IME aims to create a framework of developmentalist financing, instruments of poverty-reduction are an inherent part of IBF. For this purpose, in addition to Islamic financing of economic activity for development, *zakah* and *qard hasan* can be mentioned.

These principles within the framework of IME values indicate that IBF cannot be relegated

only to the prohibition of *riba* in the sense of *Shari'ah* or 'form' compliancy, but importantly it essentialises 'substance' as defined by IME. Thus, IBF is directly related the axioms of IME in very aspect. For instance, ethical financing is essential not only that the concepts of *rububiyah* and *tazkiyah* may be fulfilled but also that *adalah* and *ihsan* can be achieved [Ahmad, K. 1994].

3. Evaluating the Performance and Locating the Social Failure of Islamic Banking and Finance

In the previous sections, it is argued that IBF aims to fulfil the aspirations of IME by contributing to the development of the society through ethical investing. However, in looking critically at the reality and performance of IBFIs, one witnesses the overwhelming convergence with conventional banks and financial institutions in terms of operations and products at the expense of the aspirations of IME. Over the years, as part of this convergence, IBFIs have compromised on their 'moral economy' related objectives and outcomes by locating themselves within neo-classical economics. In other words, their attachment to 'efficiency' has been at the cost of 'equity,' while IME as the foundation and framework for IBFIs prioritises social as well as economic optimality by placing emphasis on 'equity.'

Thus IME, conceptually, suggests that IBF should be more than financial contracts, as it represents a holistic approach to financing a society. In addition, conceptually, Islamic finance is rooted in developmental aims, and therefore conceptualised as providing the financial means for the development of societies rather than services for the markets. Therefore, the embeddedness of IBFIs' financing in real economy is an essential feature.

A critical analysis of the performance of IBFIs, however, indicates that there is a growing divergence between the aspirations of IME and the realities of IBFIs. This divergence mainly demonstrates itself in ethical and social expectations related areas, and therefore it is valid to claim the 'social failure' of IBFIs with the evidence produced by a growing body of empirical literature. Therefore the debate in recent years has been around 'form *vs* substance' or '*Shari'ah* compliant finance *vs* the Islamic based finance,' which indeed brings the entire legitimacy of the current practice of IBF into question. It should be noted that the substance in this debate is defined through the IME's suggested ethical and developmentalist or social economy oriented value proposition, as explained above.

3.1 Locating the Social Failure in IBFIs

In the previous section, the tenants and principles of IBF are identified within the value framework of IME. These can be used to evaluate the current practice of IBF, as follows:

3.1.1 *The Relationship between IBF and the Conventional Monetary System*

IBFIs operate within the existing economic and monetary system, and therefore they are inevitably affected not only by the operation of the monetary system but also by the business cycles of the economy in which they are operating. Therefore, the ‘resilience’ of IBF during the financial crisis is an overly exaggerated issue, as when the business cycle is running into difficulty, it is inevitable that the IBFIs will also be affected, as was the case in Dubai.

Important however, is the return of *riba* or interest through different mechanisms into the IBFI operations, as interest is still used as a benchmark to measure the time cost of money in IBFIs in their project evaluation, markup value and beyond. A number of recent studies, among other Gan, Pei-Tha and Kian-Teng Kwek [2010] and Chong, Beng Soon and Liu, Ming-Hua [2009], evidence the correlation between IBFIs’ returns and the change in the interest rates and monetary operations.

Not having developed a benchmark for its operation should be considered as an important shortcoming, which results in a convergence between IBF and conventional finance and banking.

3.1.2 *Financialisation of IBF as Opposed to ‘Financing’*

As mentioned above, IBF within the IME is considered as embedded financing being directly related to the financing of the real economy. However, in recent years, through financial engineering a number of new instruments have been produced in responding to the sophisticated financial needs of the corporate and financial sectors. However, developments of such products bring IBF even closer to conventional finance by endogenising the shortcomings of conventional finance into the IBF realm. In other words, ‘financialisation’ through such new products is a result of mimicking the conventional sector. Considering that such products are responsible for the failure of the conventional financial sector, the fear of their impact on the IBF industry is important to consider.

It should be noted that the value system in which IBF is located suggests the removal of speculation and the linking financing with the real economy. However, these new products, as the controversy around *tawarruq* and *sukuk* as well as other Islamic derivatives and futures indicates, are constructed by compromising the value system of IBF. The result, therefore, has been the financialisation of IBF, which as a principle was considered detrimental to a robust economy by IME. Thus, the particular and pragmatist path followed has resulted in internalising ‘financialisation’ as an essential part of IBF, which runs against the aspirations and values of IME and IBF.

In a recent study by Asutay and Aksak [2011], the performance of IBFI indices were

examined for a number of cases and compared to conventional finance, a direct correlation between the performance of both the financial sectors is established, and it is argued with evidence that IBF does not necessarily bring stability to the financial system. It is assumed by the IME that IBF should provide stability to the financial system and should also be a moral compass for capitalism [Asutay 2007a, 2008]. However, Asutay and Aksak [2011] could not find any evidence for this, thus revealing another source of divergence between the ideals of IME and the realities of IBFIs.

3.1.3 Overwhelming Popularity of Debt Financing over Asset Based Financing

IME assumes that IBF should be based on the ideal form of asset based financing as opposed to debt financing, and therefore debt financing is discouraged, as the proposition aims to develop a healthy and stable economy by preventing the financialisation of the economy. Therefore, as mentioned above, risk sharing and profit-and-loss sharing financial instruments are prioritised to develop a participatory economy.

A critical examination of IBFIs financing, however, quickly identifies that debt financing has become the majority financing method in IBFIs. A number of studies, among others Aggarwal and Yousef [2000], Iqbal and Molyneux [2005], Zubair Hasan [2007], Nagaoka [2007] and Jan [2011] show that debt-based financing has become the major source of financing in the IBF industry as in conventional banking. Nagaoka [2007] evidences that on average, from 1984 to 2006, *murabahah* instrument financing (mark-up priced financing products, which are debt-based) constituted 88.1% of the mode of financing for the Bank Islam Malaysia Berhad, and 67.3% for the Dubai Islamic Bank for the period of 1988 to 2006. For the same period, however, *mudarabah* and *musharakah* instruments of financing (both joint venture capital products and therefore asset-based) remained on the average about 1.7% for the Bank Islam Malaysia Berhad, and 9.3% for the Dubai Islamic Bank [Nagaoka 2007]. In a more recent study, Jan [2011] also provided similar evidences, as can be seen in Table 1.

As Table 1 illustrates, financing through *musharakah*, *mudarabah* and *qard al-hassan*, which are the preferred financing methods of IME, is mostly very limited and in most of the cases is negligible if not nil. The rest of the financing in these selected banks, as in others, is conducted through *murabahah* and other debt-financing instruments. Therefore, considering that in IME equity or profit-and-loss sharing financing is considered superior to debt-like financial instruments, having IBF institutions involved in more debt-like financing is an indication that IBF has deviated from its aspirational origins and inclined towards more conventional banking and finance.

Table 1. Distribution of PLS Financing Methods in Selected IBFIs

Islamic Banks	IBF Instruments	2006	2007	2008	2009	2010
Meezan Bank	<i>Musharakah</i>	14.46%	15.15%	23.55%	22.74%	27.30%
	<i>Mudarabah</i>	0	0	0	0	0
	<i>Qard al-hassan</i>	0	0	0	0.01%	0.01%
Kuwait Finance House	<i>Musharakah</i>	0	0	0	0	0
	<i>Mudarabah</i>	0	0	0	0	0
	<i>Qard al-hassan</i>	0	0	0	0	0
ABC Bank	<i>Musharakah</i>	0	0.21%	0.32%	0.09%	0.10%
	<i>Mudarabah</i>	0	0	0.07%	0.09%	0.10%
	<i>Qard al-hassan</i>	0	0	0	0	0
Al Rajhi Bank	<i>Musharakah</i>	0	0	0	0	0
	<i>Mudarabah</i>	0	0	0	0	0
	<i>Qard al-hassan</i>	0	0	0	0	0
Bahrain Islamic Bank	<i>Musharakah</i>	4.16%	8.97%	13.40%	12.64%	11.67%
	<i>Mudarabah</i>	7.13%	8.27%	9.79%	8.75%	6.17%
	<i>Qard al-hassan</i>	0.04%	0.03%	0.02%	0.02%	0.001%
Bank Islam Malaysia	<i>Musharakah</i>	0.49%	0.51%	0	0	0
	<i>Mudarabah</i>	0.21%	0.18%	0.09%	0.08%	0.05%
	<i>Qard al-hassan</i>	0	0	0	0	0
Gulf Finance House	<i>Musharakah</i>	0	0	0	0	0
	<i>Mudarabah</i>	5.18%	0	0	0	0
	<i>Qard al-hassan</i>	0	0	0	0	0
Bank Muamalat Indonesia	<i>Musharakah</i>	N/A	16.46%	29.23%	40.21%	38.11%
	<i>Mudarabah</i>	N/A	43.10%	18.46%	12.22%	8.82%
	<i>Qard al-hassan</i>	N/A	1.12%	1.77%	2.68%	7.47%
Dubai Bank	<i>Musharakah</i>	6.98%	6.80%	16.72%	18.32%	15.07%
	<i>Mudarabah</i>	7.53%	9.83%	12.00%	9.50%	5.75%
	<i>Qard al-hassan</i>	0.03%	0.01%	0.01%	0.01%	0.01%
Qatar Islamic Bank	<i>Musharakah</i>	0.17%	0.17%	0.00%	0.23%	0.17%
	<i>Mudarabah</i>	3.37%	9.23%	5.87%	4.47%	2.91%
	<i>Qard al-hassan</i>	0	0	0	0	0

Source: [Jan 2011]

Such an outcome is again related to the fact that IBF has opted for profitability and efficiency over equity and value propositions of IME. Due to the microeconomics of credit and loans, equity oriented financial products are rather risky, while mark-up oriented *murabahah*, for example, is much less risky and brings a much higher (fixed) return.

3.1.4 Withering Development Financing

IBF, as a proposition, is considered by IME as financial institutions, which can pool financial resources for economic and social development. While IBFIs in their over thirty-five years of existence have undeniably contributed to economic growth, their contribution to economic and social development is negligible.

Since economic development is a larger concept than economic growth, the former requires the financing of value added creating industries, long-term financing and contributing to social and human development. With the emergence of IME in the 1970s, the main focus has been on how to achieve human-centred economic development, which has been imposed on IBF as an objective function. However, the performance of IBFIs over the years has not been encouraging for delivering economic and social development.

The evidence, however, does not provide much confidence in terms of development and long term financing in IBFIs. Aggarwal and Yousef [2000], Iqbal and Molyneux [2005], Zubair Hasan [2007], Nagaoka [2007] and Jan [2011] show that “Islamic banks rarely offer long-term financing to entrepreneurs seeking capital” [Aggarwal and Yousef 2000: 94]. In addition, G. A. Ahmed [2005] in the case of Sudan shows that after the initial years, Islamic banks moved away from financing agriculture and industry using profit-loss sharing schemes. Furthermore, Jan [2011] evidences that financing sectors such as agriculture, industry, and manufacturing have not played a major part in the financing strategy of IBFIs. As does Warde [2000], Jan [2011] provides detailed analysis of the investment patterns among IBFIs in various countries and demonstrates that real estate as well as foreign financial investments are preferred investment areas for IBFIs. Therefore, the contribution of IBFIs to economic development is rather elusive, as IBFs prefer to opt for short-term financing which brings a much higher return as the maturity of their financing evidences, such as the real estate market. Recalling that it was the real-estate boom which brought conventional finance into the crisis in the first place, the possible fate of IBFIs focusing on such investment areas creates unease.

In attempting to locate the impact of IBFIs on human development, Asutay [2010c] ran a simple correlation between the IBFIs assets of twenty-five countries and their respective human development index scores. The correlation analysis result does not indicate any positive correlation, indicating that IBFIs, despite expanding in their asset bases, have not contributed investment to any fields that can bring about economic and social development.

Considering that economic and social development remains a difficult challenge in most parts of the Muslim world, it is essential that IBFIs should be reconfigured to serve such a noble

cause, *a priori*. The human development index evidences that even the rich Gulf countries are still suffering from a low rate of human development. Since IME aims directly to generate an environment in which social and economic development can be achieved, the realities suggest that IBFIs are far away from realising such an objective. The difficulty is that IBFIs are further diverging away from such aspirations in everyday life.

3.1.5 *Failures in Social Responsibility*

While corporate social responsibility (CSR) is an exogenous activity for the conventional corporate and finance sector, it is an inherited part of IBF, as IME principles and foundational axioms directly refer to CSR related activities. In other words, by definition and construct IBF has to comply with CSR expectations. The IME axioms all in all, but particularly *tawhid*, *adalah*, *rububiyah*, and *tazkiyah* among others, directly refer to social development, environmental concerns, and human and economic development. Therefore, it is expected by IME that IBFIs should be CSR compliant in addition to their Shari'ah compliancy in financial terms.

The critical analysis of the performance of IBFIs, however, evidences that their CSR performance has been rather weak and poor. Among others, Sorially [2005], Dusuki [2007], Haniffa and Hudaib [2007], Hassan *et al.* [2010] and Mohd Nor and Asutay [2011] provide evidence for the lack of CSR initiatives in the IBFIs indicating that IBFIs have failed to develop a pro-actively engaged understanding in relation to IBFIs. In particular, Sorially [2005] and Dusuki [2007] show that the CSR perception of IBFIs remain within the framework of *zakah* distribution and other non-systemic charitable activities. The CSR scoring method used by Haniffa and Hudaib [2007] and Hassan *et al.* [2010] in various case studies also produces similar weak results for CSR commitment in the IBFIs industry. A recent and modest study Al-Sabti [2011] also produced evidence for poor CSR scores for Saudi Arabian Islamic banks, as the highest score that could be reached was around 0.55, which is about half the expected full CSR compliance.

An interesting example of the social failure of CSR in IBFIs is their investment attitude, as ethically CSR is expected to shape their investment strategies. However, the evidence shows that they are not much different than conventional banks and financial institutions. For example, the infamous Zamzam Towers in Makkah, which were built in very close proximity to the Kabah, the holiest place in the Muslim world and the focal point of the prayer, can be considered as an example of the 'social failure' of IBFIs. Zamzam Towers was built by financing facilitated through Islamic finance to provide up-market luxurious accommodation for high-net-worth

pilgrimages. However, even its promotional literature indicates that the project is not socially and religiously correct, as it undermines equal opportunity in this most holy place, undermines its spirituality and historicity, and damages its environmental nature. A personal discussion with the financiers and the Shari'ah scholar who approved the financing of the project however indicates that they even failed to consider such ethical issues in their decision-making. In other words, their decision-making process was based on efficiency and equity; moreover CSR issues did not even cross their minds. This is indeed a disturbing issue, as conventional banks do withdraw from projects due to their social costs, and yet the IBFIs could not even attempt to fully understand such a matter, let alone withdraw from such a project.

In sum, the scores of IBFIs and their CSR performance is rather disturbing, as it brings into the question the entire legitimacy of the IBFI proposition, because by definition IBFIs are expected to be CSR compliant as part of their fulfilment of the substance requirement of IME. In other words, CSR is an existential issue for IBFIs and unfortunately this data proves the 'social failure' of IBFIs conclusively.

3.1.6 Shortcomings in Corporate Governance Performance in IBFIs

When the current financial crisis erupted, one of the sources for such a devastating crisis was located in corporate governance (CG) structures and practices of the financial institutions. IME, being an ethical proposition, aims to develop the best practices in CG for IBFIs, as the *tawhidi* or *shuratic* [Choudhury and Hoque 2006] model suggested by IME is a much larger and robust model than the stake-holder model which is commended for its endogenising efforts of larger stake-holders in the CG as compared to the US share-holders model. Thus, IME aims to develop a comprehensive CG model for IBFIs in their practices so that the ethical value system of IME can be fulfilled.

A number of studies have been conducted to evaluate the CG performance of IBFIs. However, what is common in these studies is that none of the IBFIs have developed an understanding of Islamic CG model. Safeddine [2009], for example, evidences some governance flaws relating to audit, control, and transparency.

The other side of CG is related to the whole idea of responsible finance as articulated by IME, which requires systematic checks on financial providers as part of CG. However, the initiatives by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and IFSB (Islamic Financial Services Board) remain weak and are not generally accepted. A number of studies have investigated the Shari'ah governance of IBFIs. For example, Hasan and Asutay [2011] which examines the Shari'ah governance in terms of the practices of Shari'ah

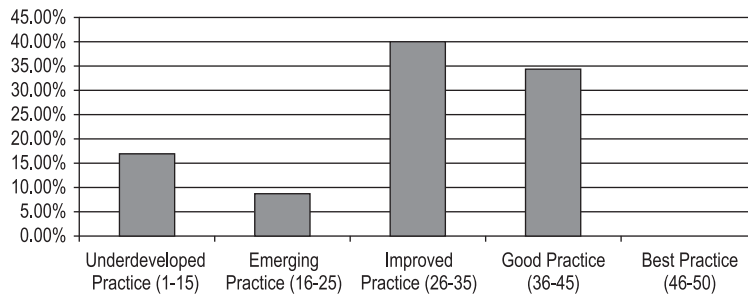


Fig. 1. The Overall Shari'ah Governance Scores

Source: [Hasan and Asutay forthcoming]

boards in relation to IFSB rules shows that there is no best practice IBF. As can be seen in Figure 1, Hasan and Asutay [forthcoming] found through the Shari'ah indexing of IFSB rules in relation to Shari'ah Boards in thirty-five IBFIs in various parts of the world that there is no best practice, as none of the sample banks could score 46-50 by being compliant with all fifty items in the IFSB rules; while 33% of the sampled IBFIs could score 36-45 and 40% of them could only score around 26-35 to be classified as 'improved practice.'

References can be made to other studies in providing further evidence for the shortcomings in CG practices. However, the common result in all the relevant studies is that CG structures have to be developed to prevent further problems in the performance of IBFIs.

3.2 Locating the Sources of Social Failure in IBFIs

In order to be able to remedy the observed failure, it is therefore important to locate the sources of this failure, and this is discussed below within the limited space available.

The paradigm shift from IME to IBF in particular with the adoption of commercial institutionalisation of IBFI since the mid-1970s represents an important divergence, as the former aimed at developing an 'Islamic based environment' in which IBF could be located. The shortcomings in developing the necessary knowledge resulted in IBFIs following a neo-classical economics framework. Thus, IME's call for social and sustainable development is not considered as an aim by IBFIs; therefore the social good is not prioritised.

In the observed social failure of IBFIs, commercial banking, as an institutional format of IBF is also important to mention; as commercial IBFIs totally ignore developmentalists efforts, their principle aim being entirely devoted to profit maximisation rather than ethical profit.

The legalistic-rational method applied by the *Shari'ah* scholars should be considered as an important part of this observed social failure, which by definition ignores the 'substance'

by prioritising the ‘form.’ While substance requires a consequentialistic approach in terms of outcomes, in the ‘form’ oriented approach, the entire emphasis is relegated to the process of constructing a product by ignoring the outcomes of the product. For this, the celebrated Islamic scholar Ibn Qayyim’s position from many centuries ago is extremely important, as he warned of *riba*-free products leading to greater ‘harm’ in the society if they were not designed according to the identified moral objectives. The debate on ‘form’ versus ‘substance’ is an essential issue, and in order to overcome the observed failures, it is essential that Shari’ah scholarship endogenises moral principals into their decision-making process.

The IBFIs as institutions have been made possible through the transformational intellectual position developed by the Islamisation of knowledge movement in the late 1960s, which aimed at Islamising the institutions of Western construct without even considering the existential question about whether the concept of commercial banking should be an institution of Islamic construct. As the history and financial anthropology of Muslim and Mediterranean geography indicates, perhaps other ‘non-banking financial institutions’ could also be considered and developed to respond to the ‘substance’ related expectations or fulfil the aspirations of IME. Because, in the existing construct, as mentioned before, there is a conflict between aims referring to social economy and developmentalism, and instruments and institutions, namely banks. Thus, with the commercial IBFIs, Islamisation of capitalism has been taking place in recent years in the Muslim world: considering that Weber argued for religious work ethics (Protestantism) generating capitalism, it seems that IBFIs are now delivering the new capitalism in the Muslim world. Indeed, it is questionable whether this is desirable considering the systematic and chronic economic and financial crises that have been experienced over many decades. Surely, IME came into existence as a response to the capitalist and socialist failures of developmentalism implying that the perceived and increasing capitalism practised by IBFIs is not necessarily fulfilling the right expectations. Thus, the institutional construct of Islamic financing in the form of commercial banks has to be questioned.

While the corporation and supply side of IBFIs is important, the demand side should also be critically analysed in assessing its importance in shaping the nature of IBFIs. Considering that the ethical finance movement in the West is very much a product demanded by ethically motivated individuals, the clients of IBFIs should be in a position to express their demands concerning the way their monies are invested by IBFIs in relation to their ‘social and developmentalist’ objectives. Thus, the role of the civil society is important to tame the ‘capitalist’ trends in IBFIs. However, evidence indicates that clients of IBFIs have surrendered themselves to

the will of *Shari'ah* boards in terms of their responsibilities with the expectation that such boards do deliver according to the ethical and social expectations. The evidence contradicts this; and therefore, a pro-active civil society is essential for the robust development of the IBF industry, which has so far been shaped by the markets.

4. Second-best Solution or Going Back to the Basic: Correcting the Social Failure

The discussion so far has clearly identified the social failure of IBF despite its financial successes. However, by definition IBFIs successes should be considered beyond their financial success, as IME assumes that IBFIs should fulfil the aims of developmentalism identified by IME.

Considering the urgent need for development in the Muslim world, as well as in the rest of the world, the crucial importance of 'moral' oriented financing cannot be denied. When examining the Human Development Index as well as other social indices, it is clear that IBF has to endogenise the developmentalism of IME into its objective function, which by definition should be part of its operations.

The 'Islamic' as a prefix in IBF suggests 'social justice,' 'social good' and 'moral oriented developmentalism' and therefore financial institutions carrying 'Islamic' in their title must respond to the responsibility imposed on them by the very title they carry. Thus, a return to the basics of IME is essential to prevent the risks of future performance imposed by the converging of IBF with conventional banks and financial institutions. In this 'return,' the implications of 'Islamic' in the title and therefore the aspirations of IME should be served through new institutions and perhaps through non-banking-financial institutions, which can include Islamic social banking [El-Gamal 2006; Asutay 2007b], Islamic microfinance [Ahmed, H. 2004; Asutay 2010a], economic empowerment oriented *awqaf* (pious foundations), *zakah* funds for development, *ar-rahn* or Islamic pawnbroking institutions [Abdul-Razak 2011], Islamic development banks, social investment institutions, and ethical funds *etc.* These institutions would not only be able to respond to the 'substance' of IBFIs beyond attachment to the 'form,' but would also contribute directly to the developmentalist expectations in the Muslim world beyond economic growth.

In short, Mith Ghamr in 1963 in Egypt with its short-lived experience, and Tabung Haji in Malaysia since 1967 have demonstrated that IBFIs can contribute to the development of society, as the first institutional phase of IBF. The 'commercial' IBF since the mid-1970's constitutes the 'second stage' of the institutionalisation in IBF. However, despite bringing economic growth through their innovations and financial pooling, they have not contributed to the development of

society nor have they managed to touch the lives of ordinary people on the streets of the Muslim world and beyond. Therefore, there is a need for an institutional development to respond to the developmentalist need. In this third stage of development, the above suggested non-banking-financial institutions and Islamic social banking can be considered along with commercial IBF to fulfil the aspirations of IME.

This new institutional formation, endogenosing ethics, can thus provide a new identity based on substantive and ethical religious tenets. In reorienting towards social banking, “the ‘Islamic’ in ‘Islamic banking and finance’ should relate to the social and economic ends of financial transactions, rather than the contract mechanics through which financial ends are achieved” [El-Gamal 2006: xiii]. In other words, a paradigm shift towards goals and policy rather than only the mechanistic and legal compliance of IBF will serve human well-being much better [Siddiqi 2004].

Conclusion

In concluding, since ‘development’ is a larger concept, IBFIs with their current structure have not been able to affect nor have they aimed at affecting the development of the societies in which they operate in a systematic manner. This does not mean that IBFIs do not have an impact on economic growth; on the contrary due to financial development and pooling of funds they do contribute to economic growth. However development, which is the aim of IME, lies beyond the growth of the economy.

It should be reiterated that ‘Islamic’ in IBFIs refers to a particular value system beyond the understanding of conventional banking; and therefore they are expected to fulfill the *maqasid* as identified through the values and norms of Islam. This suggests a socially acceptable financing option for the development of society, which by definition is in contradiction with the ‘financialisation’ trends observed in the IBF industry.

The correction of the observed ‘social and developmentalist’ failure is essential for sustainable development and therefore for fulfilling the promise of IME. In serving such objectives, new Islamic financial institutions beyond but in addition to IBFIs are necessary and essential. Therefore, in the new institutionalization stage, IBFIs should relate to the ‘substance’ and the ‘consequences’ rather than merely the ‘form,’ which would help to moderate and remedy the divergence observed in the present practices of IBFIs.

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